Supreme Court, U.S.
FILED
AUG 2 1985
JOSEPH F. SPANIOL, JR.
CLERK

(6)

No. 84-1601

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

AETNA LIFE INSURANCE CO., APPELLANT

v.

MARGARET W. LAVOIE AND ROGER J. LAVOIE, SR.

ON APPEAL FROM THE SUPREME COURT OF ALABAMA

BRIEF FOR GOLDEN RULE INSURANCE COMPANY AS AMICUS CURIAE SUPPORTING APPELLANT

DAVID A. STRAUSS
1111 East 60th Street
Chicago, Illinois 60637
(312) 962-9494

Counsel of Record

Of Counsel:

DARRELL S. RICHEY
Vice President and General Counsel
Golden Rule Insurance Company
Lawrenceville, Illinois 62439

GUY E. MCGAUGHEY, JR.
McGaughey and McGaughey
Lawrenceville, Illinois 62439

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

BEST AVAILABLE COPY

36 pp

QUESTION PRESENTED

Golden Rule Insurance Company will address the following question:

Whether a state court may constitutionally impose punitive damages on appellant for the manner in which it processed an insurance claim, when appellant's conduct was not prohibited by the insurance policy and appellant had no notice that such conduct could be the basis for an award of punitive damages.

TABLE OF CONTENTS

	Page
INTEREST OF THE AMICUS CURIAE	1
STATEMENT	2
SUMMARY OF ARGUMENT	7
ARGUMENT:	
THE RETROSPECTIVE AWARD OF PUNITIVE DAMAGES AGAINST APPELLANT VIOLATES THE CONTRACT CLAUSE AND THE DUE PROCESS CLAUSE	9
CONCLUSION	29

TABLE OF AUTHORITIES

CASES: Page

Allied Structural Steel Co. v. Spannaus, 438 U.S. 234 (1978) 8, 21, 22, 23, 26

Bridges v. California, 314 U.S. 252 (1941) 25

Brinkerhoff-Faris Trust Co. v. Hill, 281 U.S. 673 (1930) 27

Bouie v. City of Columbia, 378 U.S. 347 (1964) 27-28

Calvert Fire Insurance Co. v. Green, 180 So.2d 269 (Ala. 1965) 10-11, 12

Cambron v. Association Life Insurance Co., 405 So.2d 17 (Ala. 1981) 12

Chavers v. National Security Fire & Casualty Co., 405 So.2d 1 (Ala. 1981) 4, 12

Childs v. Mississippi Valley Title Insurance Co., 359 So.2d 1146 (Ala. 1978) 12

City of El Paso v. Simmons, 379 U.S. 497 (1965) 24

City of Newport v. Fact Concerts, Inc., 453 U.S. 247 (1981) 14, 16

Douglas v. Buder, 412 U.S. 430 (1973) 28

Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., No. 83-18 (June 26, 1985) 16

Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400 (1983) 23

Exxon Corp. v. Eagerton, 462 U.S. 176 (1983) 23

Franchise Tax Board v. United States Postal Service, No. 83-372 (June 11, 1984) 25

Gagnon v. Scarpelli, 411 U.S. 778 (1973) 28

Gelfert v. National City Bank, 313 U.S. 221 (1941) ... 24

Gertz v. Robert Welch, Inc., 418 U.S. 323 (1974) . 15-16, 17

Gulf Atlantic Life Insurance Co. v. Barnes, 405 So.2d 916 (Ala. 1981) 6

International Brotherhood of Electrical Workers v. Foust, 442 U.S. 42 (1979) 15, 16, 21

James v. United States, 366 U.S. 213 (1961) 24

Table of Authorities Continued

Page

Lake Shore & Michigan Southern Railway v. Prentice, 147 U.S. 101 (1893) 17

Lavoie v. Aetna Life and Casualty Co., 374 So.2d 310 (Ala. 1979) (*Lavoie I*) 3, 12

Lavoie v. Aetna Life and Casualty Co., 405 So.2d 17 (Ala. 1981) (*Lavoie II*) 3-4, 12

Los Angeles Department of Water & Power v. Manhart, 435 U.S. 702 (1978) 22

Manigault v. Springs, 199 U.S. 473 (1905) 26

Marks v. United States, 430 U.S. 188 (1977) 28

Monell v. Department of Social Services, 436 U.S. 658 (1978) 17

National Security Fire & Casualty Co. v. Vintson, 454 So.2d 942 (Ala. 1984) 7

Nebraska Press Association v. Stuart, 427 U.S. 539 (1976) 25

New York Times Co. v. Sullivan, 376 U.S. 254 (1964) . 25

Old Southern Life Insurance Co. v. Woodall, 326 So.2d 726 (Ala. 1976) 11-12

Pension Benefit Guaranty Corp. v. R.A. Gray & Co., No. 83-245 (June 18, 1984) 13, 27

Prentis v. Atlantic Coast Line Co., 211 U.S. 210 (1908) 25

Shelley v. Kraemer, 334 U.S. 1 (1948) 27

Shevlin-Carpenter Co. v. Minnesota, 218 U.S. 57 (1910) 14-15

Smith v. Wade, 461 U.S. 30 (1983) 14, 16

Stockholders v. Sterling, 300 U.S. 175 (1937) 24-25

Tidal Oil Co. v. Flanagan, 263 U.S. 444 (1924) 24-26

United States v. Darusmont, 449 U.S. 292 (1981) 13

United States v. Johnson, 457 U.S. 537 (1982) 15

United States v. Peltier, 422 U.S. 531 (1975) 14

United States Trust Co. v. New Jersey, 431 U.S. 1 (1977) 13, 23

Usery v. Turner Elkhorn Mining Co., 428 U.S. 1 (1976) 7, 13, 14, 27

Table of Authorities Continued

Page

Vincent v. Blue Cross-Blue Shield, 373 So.2d 1054 (Ala. 1979) 12

Welch v. Henry, 305 U.S. 134 (1938) 13

FEDERAL CONSTITUTION:

Art. I, Section 10, Clause 1 (Contract Clause) 7, 8, 9, 13, 22-28

Art. I, Section 10, Clause 1 (Ex Post Facto Clause) ... 28

Art. III 25

First Amendment 25, 26

Fourteenth Amendment, Section 1 (Due Process Clause) 7, 8, 9, 13, 26, 27-28

PRESIDENTIAL DOCUMENTS:

15 *Weekly Comp. Pres. Doc.* 387 (1979) 19

RESTATEMENTS AND TREATISES:

Restatement (Second) of Torts, § 908(1) (1977) 14

Restatement (Second) of Torts, § 909 (1977) 17

McCormick's Handbook of the Law of Evidence (E. Cleary ed. 1972) 17

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

No. 84-1601

AETNA LIFE INSURANCE CO., APPELLANT

v.

MARGARET W. LAVOIE AND ROGER J. LAVOIE, SR.

ON APPEAL FROM THE SUPREME COURT OF ALABAMA

BRIEF FOR GOLDEN RULE INSURANCE COMPANY AS AMICUS CURIAE SUPPORTING APPELLANT

INTEREST OF THE AMICUS CURIAE

This case concerns the power of a state court to impose punitive damages liability on an insurance company on a retroactive basis — that is, because the insurer denied a claim in a manner that was not wrongful when it occurred. Golden Rule Insurance Company—which began 45 years ago in the basement of a home in a small town—is a family-owned business and, until very recently, remained one of the many small insurance companies in the nation. The punitive damages awarded against appellant in this case would have constituted 14 percent of Golden Rule's entire benefit payments for the year 1981. A massive, unpredictable damages award presents a particularly severe danger to the efforts of an insurer of the size of Golden

Rule to meet its customers' needs. For this reason, Golden Rule may be able to provide the Court with a useful perspective on the question it addresses.*

STATEMENT

1. Appellant, an insurance company, agreed with the City of Mobile, Alabama, to provide group health and medical insurance to City employees. Appellee Roger Lavoie is a retired City employee; appellee Margaret Lavoie, his wife, is insured as a dependent. In February 1977, Mrs. Lavoie, who had suffered from osteoarthritis for many years, complained to her physician of anxiety, gastrointestinal disorders, and arthritis pains. Her physician recommended that she be admitted to a hospital. J.S. App. 2a-3a. During Mrs. Lavoie's 23-day stay in the hospital, her physician "ordered medical diagnostic tests * * *, an electroencephelogram (EEG), and electrocardiogram (EKG), a gastrointestinal series (GI series), a barium enema, a computer assisted tomogram (CAT scan) and various other tests." *Id.* at 3a. When she was discharged from the hospital, the "discharge summary" prepared by her physician reported that her arthritis was not unusually severe for her age, that she had no gastrointestinal disorder, and that her symptoms were primarily psychosomatic (*id.* at 4a).

On March 3, 1977, the hospital submitted a bill to appellant for approximately $3,000. The claim was reviewed by Brenda Harris, an employee in appellant's Mobile office, and by Jean Becker, a Senior Claims Examiner in appellant's Hartford office. Appellant paid almost half the claim but denied approximately $1,650 of it. J.S. App. 4a-6a. Appellant notified appellees of the denial on June 3, 1977, explaining to appellees that the claim was not covered by the City of Mobile policy because "it appears the evaluation and test could have been performed on an out-patient basis * * * [and] the CT Brain

---

*Letters from counsel of record for each of the parties consenting to the filing of this brief have been filed with the Clerk of the Court.

Scan, EEG and EKG * * * are not usual and customary procedures for the diagnosis given." *Id.* at 6a.

Following this initial partial denial of appellees' claim, appellees' physician wrote two letters explaining his actions. These letters were reviewed by Harris and by Senior Claims Examiner Hutton. They determined that appellant should continue to deny appellees' claim and so notified appellees in December 1977. Subsequently, appellant obtained other material concerning appellees' claim from the hospital's files. These documents, together with the rest of the file except for the physician's letters, were reviewed by Senior Claims Examiner Mann and by Dr. Swan, a physician employed by appellant. They, too, concluded that appellant should persist in its partial denial of the claim. Appellees were notified of this conclusion in August 1978. J.S. App. 6a-10a.

2. Appellees then brought this suit in Alabama state court. They sought $1,650 for an alleged breach of contract and, in their final amended complaint, $30 million in compensatory and punitive damages (see J.A. 24-33) for various alleged torts arising out of appellant's refusal to pay their insurance claim. See J.A. 6-33.

The trial court dismissed the tort counts of the complaint on the ground that they failed to state a claim on which relief could be granted. See *Lavoie v. Aetna Life and Casualty Co.* (*Lavoie I*), 374 So. 2d 310, 310 (Ala. 1979). The Alabama Supreme Court reversed, stating (*id.* at 312): "[T]his court has not foreclosed the possibility of recovery in tort for the bad faith refusal of an insurer to pay legitimate benefits due under an insurance policy. * * * This is not to say * * * that this court will in fact recognize such a theory. It merely means that sufficient facts have not been presented in an actual case so as to genuinely pose the issue for our decision one way or the other."

On remand, the trial court granted summary judgment for appellant on the tort claims. See J.A. 3; *Lavoie v. Aetna Life and Casualty Co.* (*Lavoie II*), 405 So. 2d 17, 18 (Ala. 1981). While an appeal was pending in the Alabama Supreme Court,

that court decided *Chavers v. National Security Fire & Casualty Co.*, 405 So. 2d 1 (1981), in which it announced that it was, for the first time, "recogniz[ing] the intentional tort of bad faith in first party insurance actions." *Id.* at 6. The Alabama Supreme Court then reversed the entry of summary judgment against appellees and remanded for reconsideration in light of *Chavers*. *Lavoie II*, *supra*.

On the second remand, the case was tried to a jury, which returned a verdict in favor of appellees. It awarded them $1,650 on their breach of contract claim and $3.5 million in punitive damages on the tort claim. J.S. App. 1a; J.A. 4.

3. a. The Alabama Supreme Court affirmed by a vote of 5-4. J.S. App. 1a-63a. The court first determined that the evidence was sufficient to show that appellant had committed the newly-created tort (*id.* at 12a-31a). The court relied on three facts as the basis for this conclusion: first, that while appellant's employees had reviewed many of Mrs. Lavoie's medical records, they did not obtain certain other records that were available from the hospital (*id.* at 13a-14a, 26a); second, that appellant's claims examiners did not consult a physician before making their initial determinations to deny appellees' claim in part (*id.* at 20a-21a, 25a); and third, that this failure to consult a physician early in the process violated appellant's internal rules (*id.* at 13a, 18a, 21a, 31a). The Alabama Supreme Court did not at any point identify evidence suggesting that appellant had adopted policies likely to lead to the denial of meritorious claims; that any of appellant's employees acted out of malice or personal animosity toward appellees; that appellant's employees had determined to deny appellees' claim before they considered its merits; or that appellant's employees had denied the claim even though they believed that it should be allowed. Instead, the court based its decision solely on the procedures followed by appellant's employees: the manner in which the physician was involved in the process of adjudicating the claim, and the thoroughness with which Mrs. Lavoie's medical records were examined.

In addition, the Alabama Supreme Court specifically rejected appellant's argument that because its decision to deny appellees' claim was, in fact, reasonable, it should not be held liable for the tort of bad faith failure to pay an insurance claim. Appellant pointed out that there was conflicting medical testimony at trial concerning whether Mrs. Lavoie's treatment was medically reasonable and necessary and that appellees' breach of contract claim had gone to the jury. Appellant urged that since its decision to deny part of the claim was therefore supported by reasonable arguments, it could not be said to have acted in bad faith; it simply had made a legitimate decision to deny benefits that turned out to be incorrect. J.S. App. 25a.

The Alabama Supreme Court did not question that appellant's partial denial of appellees' claim was reasonable; on the contrary, the court appeared to acknowledge that there were legitimate grounds supporting a partial denial of the claim. But the court ruled that the actual reasonableness vel non of appellant's decision was irrelevant. The court's discussion was as follows (J.S. App. 25a-26a):

> Two of five physicians testifying at trial stated that [appellant's] actions in denying the claim were reasonable because the charges in question were not shown to be medically "necessary for the treatment of the injury or disease concerned;" the language contained in the policy exclusion. Nevertheless, [appellant's] argument is critically defective in that *at the time of each successive denial* [appellant] *had never once consulted any medical authority.* That [appellant] is now capable of creating a fact issue on the contract claim through expert testimony does not, and cannot, belie the fact that [appellant] never sought medical consultation, nor reviewed the treating physician's detailed medical reports, nor reviewed any progress notes before denying an admittedly complicated medical claim. A thousand experts testifying retrospectively could not avert the fact that, without a doubt, [appellant] recklessly disregarded the facts and proofs of claim submitted by the Lavoies. *Gulf Atlantic [Life] In-*

> *surance Co.* [*v. Barnes*], 405 So. 2d [916,] 924 [(Ala. 1981).[1]]

The court also rejected appellant's contention that the award of punitive damages was excessive (J.S. App. 33a-38a), stating that it could not conclude that "the verdict was a result of bias, passion, prejudice, or some other improper motive" (*id.* at 38a).

b. Chief Justice Torbert, in a dissenting opinion joined by Justice Beatty (J.S. App. 40a-56a), stated that he was "unable to find any evidence that would authorize a jury to find that [appellant] knew no debatable reason [for denying appellees' claim] existed. In fact, the evidence supports the conclusion that [appellant] thought, and, as it turns out, was correct in thinking, that a debatable reason did exist and therefore that denial of the claim was proper." *Id.* at 56a. Chief Justice Torbert also noted that "[t]he tort of bad faith breach of an insurance contract was judicially created to fill a remedial void" (*id.* at 40a) and that "[t]he whole question of bad faith by insurance companies might be an issue more properly addressed by the legislature" (*id.* at 44a). He further remarked that he would view a bad faith failure to pay an insurance claim as a breach of an implied term of the contract for which the insured could receive consequential damages such as for "inconvenience, annoyance, [or] loss of job or business" (*id.* at 40a) but not punitive damages. He explained that this approach would avoid "the excesses of passionate juries" and would enhance the stability of expectations, which "is certainly important in the insurance context, where predictability * * * is necessary in calculating premiums." *Id.* at 41a.

Justice Maddox, in an opinion joined by Justice Shores, also dissented (J.S. App. 56a-63a). He concluded that "it is apparent

---

[1]On the page cited by the court from *Gulf Atlantic Life Insurance Co.*, the following sentence appears: "Of course, if a lawful basis for denial actually exists, the insurer, as a matter of law, cannot be held liable in an action based upon the tort of bad faith." This appears to be precisely the opposite of what the court said in this case. See also pages 19-20, *infra*.

that the insureds were not entitled to recover on the bad faith claim, because they failed to meet their burden of showing that the insurer 'had no legal or factual defense to the insurance claim.' *National Security Fire & Casualty Company v. Vintson*, 454 So. 2d 942 (Ala. 1984)." J.S. App. 56a.

SUMMARY OF ARGUMENT

A. At the time appellant issued its insurance policy to the City of Mobile, and at the time appellant denied appellees' claim, it had no way of knowing that its actions could give rise to a massive award of punitive damages. The terms of the insurance policy did not impose on appellant the duty that the Alabama Supreme Court found to have been breached, and certainly did not specify that a breach of such a duty could be punished by a monetary penalty far in excess of any actual damages. The controlling decisions of the Alabama Supreme Court at the time appellant acted contained explicit statements to the effect that even if an insurer maliciously denied a claim in bad faith, the insured could not be awarded damages beyond the amount specified in the policy plus interest. And while it is reasonable to presume that appellant knew it had an implicit duty to act in good faith, the actions that the Alabama Supreme Court declared to be wrongful in this case do not correspond to any common sense conception of "bad faith."

B. This decision of the Alabama Supreme Court to impose retroactive punitive damages liability on appellant violates the Contract Clause and the Due Process Clause because it is not rationally related to the promotion of any state interest and it places an unreasonably harsh and oppressive burden on appellant. This Court has stated that it will "hesitate to approve the retrospective imposition of liability on any theory of deterrence or blameworthiness." *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 17-18 (1976) (citations omitted). That is the only theory supporting an award of punitive damages. It serves no rational state purpose to impose punishment on appellant for conduct that appellant could not have known was wrongful at the time it occurred.

Moreover, even if some purpose could be served by imposing retroactive liability on appellant, an award of punitive damages is a particularly indiscriminate and arbitrary means of furthering that purpose. Punitive damages bear no necessary relationship to any loss actually suffered, and juries exercise almost standardless discretion in awarding punitive damages. In addition, no purpose is served by awarding punitive damages against appellant for actions of employees that deviate from appellant's general policies and procedures, as the Alabama Supreme Court did here. That is especially true where, as here, the court below did not dispute that the denial of appellees' claim was, in fact, reasonable. Indeed, important social purposes are *dis*served when insurers are given such a strong incentive to pay unmeritorious claims.

Finally, the decision of the Alabama Supreme Court is unreasonably burdensome because it imposes retroactive liability in an area governed by a contract, and because the imposition of retrospective liability on an insurer is particularly disruptive. An insurer can function only if it is able to predict, with reasonable certainity, the liabilities to which it will be exposed. As this Court has explained, "'[d]rastic changes in the legal rules governing * * * insurance funds'" can " 'jeopardize[] the insurer's solvency and, ultimately, the insureds' benefits.'" *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 247 (1978) (citation omitted). The unforseeable imposition of a $3.5 million liability because of the denial of a $1,650 claim is such a drastic and unreasonable change.

C. Because the decision of the Alabama Supreme Court interferes with obligations settled by contract, imposes a harsh and oppressive burden on appellant, and is not rationally related to the promotion of a state interest, it violates the Contract Clause and the Due Process Clause. While the Court has not applied the Contract Clause to decisions by state courts interpreting state statutes, there is no reason to exempt all actions by state courts from scrutiny under the Contract Clause. And even if the Contract Clause does not apply to the decision of the court below, this Court has frequently recog-

nized that a judicial decision imposing an unreasonable retroactive liability violates the Due Process Clause.

ARGUMENT

The Retrospective Award Of Punitive Damages Against Appellant Violates The Contract Clause And The Due Process Clause

The Alabama Supreme Court has upheld the imposition of massive punitive damages on appellant for actions that the court did not declare to be wrongful until well after appellant had engaged in them. We submit that this decision by the court below alters the terms of appellant's contract with appellees, is not a rational means of promoting any state interest, and subjects appellant to a harsh and arbitrary burden. It therefore violates the Contract Clause of the Constitution, Art. I, Sec. 10, Cl. 1, and the Due Process Clause of the Fourteenth Amendment.

We recognize that the tort created by the Alabama Supreme Court and retroactively applied to appellant was denominated a "bad faith" failure to pay an insurance claim. In urging that the court should not have imposed retroactive punitive damages liability on appellant, we are of course not suggesting that appellant, or any other insurer, has a vested right to act in bad faith. If the court below had simply held that an insurer will be responsible for the consequences of actions that plainly constituted a malicious or bad faith processing of claims, our view of this case would be quite different.

But in this case, the courts below have imposed not compensatory but punitive damages, and they have imposed these damages for conduct far removed from the core of any reasonable conception of bad faith. We do not, for present purposes at least, question that Alabama has the power to define its tort of "bad faith" in any way it chooses. But the state may not define that tort in a novel way and then impose punitive damages for acts that occurred before the tort was even created. If a state regulatory agency were to issue rules governing the processing

of insurance claims, apply those rules on an ex post facto basis to conduct that occurred well before the rules were announced, and then impose fines in the millions of dollars on insurers whose previous conduct did not conform to those rules, the agency's actions would clearly be unconstitutional. We submit that the actions of the Alabama Supreme Court in this case are indistinguishable from those of such a hypothetical agency.

A. It is clear that when appellant entered into the contract of insurance that gave rise to this litigation, and took the actions for which it was held liable, it had no fair notice that its actions could give rise to massive punitive damages liability. Appellant entered into a contract of insurance with the City of Mobile in 1967. J.A. 35. Appellees submitted the claim that gave rise to this litigation in March 1977, and appellant initially denied that claim in June 1977. At that time, Alabama law did not recognize a tort of bad faith failure to pay an insurance claim. On the contrary, the opinions of the Alabama Supreme Court strongly suggested that no such tort existed.

In *Calvert Fire Insurance Co. v. Green*, 180 So. 2d 269 (Ala. 1965), an insured asserted that the insurance company negligently delayed the payment of his claim. The Alabama Supreme Court unanimously overturned a judgment in favor of the insured, holding that the insurance company had no duty to exercise due care in adjusting claims. The court quoted with approval the following statement from a treatise (*id.* at 271; citation omitted):

> "It has been held that, in the absence of statutes, the insured cannot recover damages beyond legal interest because of the insurer's delay or refusal to pay the amount of a loss. And even where the insurer's action was wilful, such as refusing to pay a loss in order to take advantage of the insured's need for ready money wherewith to re-establish his business, it did not constitute a tort so as to entitle the insured to damages beyond interest."

The court also endorsed "the principle that a claim for damages for the mere nonpayment of money due under a contract, above

or in addition to interest, cannot be recovered." *Ibid.* And the court declared (*id.* at 272): "We cannot defeat the express terms of a policy of insurance by judicial interpretation; we must enforce the contract as it is written, and not attempt to make a new contract for the parties."

In 1976 — shortly before the events that gave rise to this decision — the Alabama Supreme Court, again without dissent, ruled that an insured's claim that an insurance company "fraudulently and maliciously failed to pay the claims made under the policy" should have been dismissed because it "fails to state a claim upon which relief may be granted sounding in tort." *Old Southern Life Insurance Co. v. Woodall*, 326 So. 2d 726, 732. The court held that such a claim "sounds in contract" (*ibid.*), thus making it clear that no punitive damages would be awarded even if an insurer "fraudulently and maliciously refus[ed] to pay a claim" (*ibid.*).[2]

So far as we can determine, this was the state of the law in Alabama when Harris, Becker, and Hutton reviewed appellees' claim and denied it in part. It was not until April 1978 — ten months after the initial denial of appellees' claim — that the Alabama Supreme Court even went so far as to say that it "has

---

[2]We note that the *Old Southern* opinion contains the following statements (326 So. 2d at 732):

> There might be circumstances under which the failure to pay a claim under a policy of insurance would create a claim upon which relief may be granted sounding in tort, but such circumstances are not presented in this case. * * * We need not decide that question since, under the record before us, there are no circumstances shown which indicate that the company tortiously denied the claim.

The insured in *Old Southern*, however, had alleged a fraudulent and malicious refusal to pay a claim, and the Alabama Supreme Court ruled that the insured had failed to state a cause of action. Thus, this language in the opinion must refer to the possibility that some extraordinarily egregious action by an insurer could give rise to liability — not to the possibility that an allegation like appellees', which is indistinguishable from the allegation made by the insured in *Old Southern*, could be actionable.

not rejected first party bad faith tort actions against an insurer." *Childs v. Mississippi Valley Title Insurance Co.*, 359 So. 2d 1146, 1152. As we noted, the court reiterated this position on the first appeal of this case (*Lavoie I*, 374 So. 2d at 311-312).[3]

In *Chavers v. National Security Fire & Casualty Co.*, *supra*, the court announced the creation of the tort. In cases decided the same day, the court referred to *Chavers* as the decision in which it "recognized the intentional tort of bad faith in first party insurance actions." *Lavoie II*, 405 So. 2d at 18; see, *e.g.*, *Cambron v. Association Life Insurance Co.*, 405 So. 2d 17 (Ala. 1981). Moreover, the court in *Chavers* explicitly retreated from the "seemingly broad" decision in *Calvert Fire Insurance Co.* — a decision that had appeared to preclude any actions against an insurer for failure to pay a claim. See 405 So.2d at 5. But *Calvert Fire*, not *Chavers*, was the latest authoritative pronouncement of the Alabama Supreme Court at the time of the events that gave rise to this suit.

B. The Alabama Supreme Court has, therefore, retroactively imposed a punishment — punitive damages — on appellant for acts that could not have given rise to such punishment under the law in existence either at the time appellant entered into its contract with the City of Mobile or at the time of the actions for which appellant was held liable. In Part C, *infra*, we show that a retrospective imposition of punitive liability in these circumstances by a court violates both the Contract Clause and the Due Process Clause.

---

[3]See also *Vincent v. Blue Cross-Blue Shield*, 373 So. 2d 1054, 1056-1057 (Ala. 1979) (Jones, J., concurring) (footnote omitted) (remarking that "it is apparent that counsel for both parties, with the cooperation of the trial Court, were seeking to structure a convenient and inexpensive vehicle through which this Court could deliver a more definitive follow-up on the dicta * * * respecting the potential tort remedy in Alabama for bad faith breach of contract"); *id.* at 1056-1065 (endorsing the creation of such a tort); *id.* at 1065-1068 (Embry, J., dissenting) (same).

As our discussion in Part C will demonstrate, while there may be room for disagreement over the specific constitutional rubric that applies to the actions of the court below, this Court, in its decisions interpreting the Due Process Clause, has made clear the minimum requirements that must be met by any measure that imposes retrospective liability on a person. First, "retroactive [measures] * * * have to meet a burden not faced by [measures] that ha[ve] only future effects." *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, No. 83-245 (June 18, 1984), slip op. 11; see *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 16-17 (1976). Second, a retroactive measure must be "supported by a legitimate [state] purpose furthered by rational means" (*Pension Benefit Guaranty Corp.*, slip op. 11). That is, the fact that there is a rational basis for applying a measure prospectively is not sufficient to uphold its retrospective application; a state must provide an independent "justification for the retrospective imposition of liability" (*Turner Elkhorn Mining Co.*, 428 U.S. at 17). "The retroactive aspects of [a measure], as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former." *Ibid.* Third, a retrospective imposition of civil liability will violate the Due Process Clause if it is "particularly 'harsh and oppressive.'" *United States Trust Co. v. New Jersey*, 431 U.S. 1, 17 n.13 (1977), quoting *Welch v. Henry*, 305 U.S. 134, 147 (1938); see, *e.g.*, *Pension Benefit Guaranty Corp.*, slip op. 15; *United States v. Darusmont*, 449 U.S. 292, 299 (1981).

The decision of the Alabama Supreme Court fails to meet these minimum standards. Its retroactive imposition of punishment, for conduct that appellant could not reasonably have known was wrong, furthers no state interest. The form of that punishment — punitive damages — is particularly likely to impose an arbitrary and irrational burden. And the court below has imposed this highly disruptive form of liability on the business of insurance, which is not only governed by contracts that parties rely on to preserve the stability of their expecta-

tions but is an area in which predictability is of paramount importance.

1. In *Usery v. Turner Elkhorn Mining Co.*, *supra*, the Court stated: "[W]e would * * * hesitate to approve the retrospective imposition of liability on any theory of deterrence or blameworthiness." 428 U.S. at 17-18 (citations omitted). These are the *only* purposes of an award of punitive damages — to punish a blameworthy defendant and to deter others from similar conduct. See, *e.g.*, *Smith v. Wade*, 461 U.S. 30, 54 (1983); *City of Newport v. Fact Concerts, Inc.*, 453 U.S. 247, 266-267 (1981); Restatement (Second) of Torts § 908(1) (1977). When the Alabama Supreme Court held that the $3.5 million punitive damages award against appellant was not excessive, it explicitly stated that deterrence and punishment were the interests served by punitive damages. See J.S. App. 34a.

As the Court recognized in *Turner Elkhorn Mining Co.*, these interests are seldom furthered by a retrospective imposition of liability. The prospect of punishment for violation of a prohibition can only deter a person who is aware of the prohibition, and it makes no sense to inflict retribution on a person who could not reasonably have known that he did wrong. By the same token, a prospective rule will, in general, fully deter all those who may be contemplating wrongful conduct. See, *e.g.*, *United States v. Peltier*, 422 U.S. 531, 542 (1975); *Turner Elkhorn Mining Co.*, 428 U.S. at 40 n.5 (Powell, J., concurring). See also *Shevlin-Carpenter Co. v. Minnesota*, 218 U.S. 57, 68-70 (1910) (upholding the constitutionality of an award of punitive damages only after noting that "[t]he law in controversy has no *ex post facto* element or effect in it").

We recognize, of course, that there may be instances in which deterrent purposes will be served by penalizing conduct that had not been unequivocally declared wrongful at the time it occurred. This will be true if the conduct is obviously or intrinsically wrong, or if it is reasonable to expect a person to have anticipated that such conduct would be declared unlawful. See, *e.g.*, *United States v. Johnson*, 457 U.S. 537, 560-561 (1982).

But the conduct of appellant's employees that formed the basis of the massive punitive damages award against appellant was not in any sense malum in se. As we noted, the Alabama Supreme Court, in upholding the jury's verdict, did not identify any evidence suggesting that any employee of appellant denied appellees' claim with malice or out of a desire to cheat or defraud appellees. Nor did the court indicate that appellant gave no consideration to appellees' claim or only sham consideration. Rather, the Alabama Supreme Court objected to somewhat technical details of the way in which appellant's employees processed the claim: it believed that they should have considered other medical records besides the numerous records that were before them, and it concluded that they should have submitted appellees' claim to a physician earlier in the process.

There is, we assume, no constitutional impediment to a state court's deciding to regulate an insurer's practices in such detail. But no deterrent purpose — or any other discernible purpose — is served by punishing appellant because its employees failed to anticipate that such a detailed regulatory code would be imposed by the court long after they had acted.

2. a. Even if a purpose were served by imposing a retroactive penalty on appellant, the form of the penalty chosen by the Alabama Supreme Court — a punitive damages award determined by a jury — is an indiscriminate and irrational means of furthering that purpose. Punitive damages are an "extraordinary sanction" (*International Brotherhood of Electrical Workers v. Foust*, 442 U.S. 42, 48 (1979)) in part because they are an exceptionally crude means of furthering the state's objectives. As this Court has explained in limiting punitive damages awards in defamation actions (*Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 350 (1974)):

> In most jurisdictions jury discretion over the amounts awarded [as punitive damages] is limited only by the gentle rule that they not be excessive. Consequently, juries assess punitive damages in wholly unpredictable

> amounts bearing no necessary relation to the actual harm caused. * * * [P]unitive damages are wholly irrelevant to the state interest that justifies a negligence standard for private defamation actions. They are not compensation for injury. Instead, they are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence.

Seven Members of this Court have agreed that " 'the alleged deterrence achieved by punitive damages awards is likely outweighed by the costs — such as the encouragement of unnecessary litigation and the chilling of desirable conduct — flowing from the rule, at least when the standards on which the awards are based are ill-defined.' " *Smith v. Wade*, 461 U.S. at 59 (Rehnquist, J., dissenting), quoted in *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, No. 83-18 (June 26, 1985), slip op. 6 n.4 (Brennan, J., dissenting). The "standards" on which the award of punitive damages against appellant was based were ill-defined indeed: they did not even come into existence until after the conduct that formed the basis of the claim against appellant had already occurred; they then varied from case to case (see pages 5-6 and note 1, *supra*); and they do not correspond to any common sense notion of what constitutes bad faith.[4]

---

[4]The dangers of indiscriminate and excessive punitive damages awards are heightened when the defendant is an insurance company. This Court has noted that a defendant perceived by a jury as having a "deep pocket" is particularly likely to be subject to excessive punitive damages awards. *City of Newport*, 453 U.S. at 270-271. See also *International Brotherhood of Electrical Workers*, 442 U.S. at 50-51 n.14 ("[I]t cannot be ignored that punitive damages may be employed to punish unpopular defendants. * * * Community hostility toward unions, management, or minority views can thus find expression in punitive awards."); *Gertz*, 418 U.S. at 350. In most jurisdictions, the general rule is that evidence that a defendant is protected by liability insurance is inadmissible. See, *e.g.*, *McCormick's Handbook of the Law of Evidence* (E. Cleary ed. 1972) 479. The reason for this rule is that a jury is too likely to act irrationally when afforded an opportunity to benefit an injured plaintiff at the expense of an insurance company. Those factors make it likely that even a prospective award of punitive damages in a case such as this will be arbitrary and irrational.

b. The decision of the Alabama Supreme Court to award retroactive punitive damages in this case was irrational for the additional reason that the award was made against appellant, when it was the actions of appellant's employees that the court determined were tortious. The court did not uphold the punitive damages award against appellant on the basis of evidence that appellant's policies or internal procedural rules resulted in the bad faith denial of appellees' claim (cf. *Monell v. Department of Social Services*, 436 U.S. 658, 690-695 (1978)); on the contrary, the court criticized appellant's employees for deviating from those rules. See, *e.g.*, J.S. App. 13a, 18a, 21a, 31a. Appellant's liability therefore appears to be based on a theory of respondeat superior. Notably, it is not clear that respondeat superior liability in punitive damages could be imposed in a case of this kind under the rule adopted by the Restatement of Torts. See Restatement (Second) of Torts § 909 (1977). See also *Lake Shore & Michigan Southern Railway v. Prentice*, 147 U.S. 101, 110 (1893): "Though the principal is liable to make compensation for a [tort committed] by his agent, he is not liable to be punished by exemplary damages for an intent in which he did not participate."

But whatever the correct tort law rule, it is difficult to see what rational state purpose is advanced by imposing massive punitive liability on appellant for acts of its employees that are inconsistent with company policies and procedures. This Court has said that the principal purposes served by the doctrine of respondeat superior are as follows (*Monell*, 436 U.S. at 693-694; citations omitted):

> [T]wo justifications tend to stand out. First is the common-sense notion that no matter how blameless an employer appears to be in an individual case, accidents might nonetheless be reduced if employers had to bear the cost of accidents. Second is the argument that the cost of accidents should be spread to the community as a whole on an insurance theory.

The second justification mentioned by the Court obviously cannot justify an award of punitive damages; there is no possible justification for taking from appellant's stockholders and other customers, who have done no wrong, in order to give appellees a windfall that vastly exceeds any loss they have suffered.

The first justification identified by the Court is also a questionable basis for imposing respondeat superior liability for punitive damages, even when no element of retroactivity is involved. The threat of damages will, of course, encourage an employer to take steps to reduce the likelihood that its employees will injure others. When only compensatory damages are imposed on the employer, the employer is forced to internalize the true costs of the employee's wrongs, and it can be argued that the employer will have the proper incentive to reduce to an optimal level the number of wrongful acts committed by its employees. But when an employer is threatened with a massive punitive damages award that is utterly unrelated to any actual damage that an employee might do, its incentive is to take excessive measures in an attempt to avert any possibility of a situation in which a jury might impose such an award.

The award against appellant, for example, will give an insurer an incentive to require its employees to pay every remotely arguable claim. The result will be the payment of unjustified claims—to the detriment of the insurer's other customers, whose premiums will have to be raised to keep up with higher claims costs. Society has no interest in compelling insurers to act in this way.[5] And if, as in this case, the insurer cannot even

---

[5]Indeed, in a situation such as that presented by this case, there is an important social interest in encourgaging insurers to examine claims closely and not to pay them uncritically. In the health care market, often only the insurer has a financial incentive to try to reduce costs. As President Carter explained in proposing to Congress legislation to contain hospital costs:

> The hospital sector is fundamentally different from any other sector in our economy. Normal buyer-seller relationships and normal market

know in advance the nature of the conduct on the part of its employees that will give rise to a punitive damages award against it, a hopelessly irrational element is introduced into its planning.

c. Finally, the Alabama Supreme Court ruled that because appellant's employees acted incorrectly in evaluating appellees' claim, appellant could not escape an award of punitive damages even by demonstrating that it in fact had a reasonable basis for denying that claim. See pages 5-6, *supra*, quoting J. S. App. 25a-26a. Indeed, it appears that under the reasoning of the Alabama Supreme Court, appellant could have been held liable in punitive damages even if it had demonstrated in court that it was entirely *correct* in denying appellees' claim; the court stated that even if "[a] thousand experts" testified that an insurer's decision to deny a claim was reasonable, the insurer could be held liable if the employees who made the decision did not have sufficient evidence before them when they acted. J.S. App. 26a.

As we noted, this ruling by the Alabama Supreme Court marked a sharp departure from the law it had previously established. See pages 5-6 and note 1, *supra*. It is also a further irrational aspect of the court's approach. Whatever the merit of imposing a penalty on an *employee* who acts improperly — and that would ordinarily be a matter best left to internal disciplin-

---

forces do not exist. The consumer of services — the patient — rarely pays the bill directly. Nor does the patient decide what services he or she will receive in the hospital. The person who makes those decisions — the physician — does not pay the bill either, and therefore has little or no incentive to see that services are provided in an efficient manner. Often, doctors do not even know the costs of the tests and x-rays they order.

15 Weekly Comp. Pres. Doc. 387-388 (1979).

By imposing on appellant a crushing liability for making a reasonable decision not to pay a claim for what turned out to be unnecessary tests, the decision of the court below creates a perverse incentive for the only actor in the health care market that is in a position to help remedy the important national problem of rising health care costs.

ary mechanisms — it makes little or no sense to punish *appellant* when its procedures did, after all, lead to a correct result: they resulted in the denial of a claim that appellant had a reasonable basis for denying.

In sum, the court below has imposed a massive and arbitrarily-determined penalty on appellant for the breach of a duty that did not exist — and was certainly not thought to give rise to a punitive damages award — when the alleged breach occurred; and it has imposed this penalty even though it has no quarrel with the procedures appellant has officially prescribed for its employees, and even though the procedures followed in this case led to a reasonable denial of a claim. This is the paradigm of a "harsh and oppressive" penalty that serves no rational state interest.

3. Finally, the Alabama Supreme Court has imposed retroactive liability in an area — the business of insurance — where expectations are settled by contract and where the stability of expectations is exceptionally important. The rights of appellees against appellant were comprehensively defined by the insurance policy issued by appellant to the City of Mobile (J.A. 34-48).[6] That contract contained no provision requiring appellant to process claims in the manner demanded by the Alabama Supreme Court, and it certainly did not provide for large monetary penalty to be imposed on the insurer if it processed a claim in an incorrect manner. As we explain below (pages 22-27, *infra*), the decision of the Alabama Supreme Court impaired the obligations of that contract and accordingly violated the Contract Clause of the Constitution.

But even if the Contract Clause does not apply of its own force in this case, that Clause reflects "the high value the Framers placed on the protection of private contracts." *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 245 (1978). "Contracts enable individuals to order their personal and busi-

---

[6]Since the policy was negotiated between appellant and the City of Mobile, there is no reason to suspect that its terms reflect any significant inequality in bargaining power.

ness affairs according to their particular needs and interests. Once arranged, those rights and obligations are binding under the law, and the parties are entitled to rely on them." *Ibid.* Because parties enter into a contract in order to secure certain expectations, a retroactive measure is particularly burdensome and unfair when it interferes with rights secured by a contract.

In addition, the retrospective imposition of liability on an insurer is extraordinarily disruptive because in the business of insurance, as this Court has said, "the element of reliance [is] vital" (*Allied Structural Steel Co.*, 438 U.S. at 246). Insurers constantly incur liabilities; the successful operation of an insurance business depends on calculating the liabilities that the insurer will face and establishing premiums and reserves accordingly. As the Court has noted, a punitive damages award is always unpredictable in its amount: "[b]ecause juries are accorded broad discretion both as to the imposition and amount of punitive damages, the impact of these windfall recoveries is unpredictable and potentially substantial." *International Brotherhood of Electrical Workers*, 442 U.S. at 50 (citations omitted). The award imposed on appellant was also unpredictable in its occurrence, because it was imposed for conduct that appellant could not have known was wrongful at the time. Appellant could not possibly have predicted that the procedures followed in refusing — reasonably — a $1,650 claim would lead to a $3.5 million damages award, and it will be extremely difficult for appellant or another insurer rationally to take the possibility of such awards into account in the future.

An insurer is in an important sense a trustee for those whom it insures. The insurer's ability to pay meritorious claims is of primary importance to its customers, and an action that undermines its ability rationally to plan to meet its obligations threatens, first and foremost, the security that its customers have sought. This Court has made these precise points on more the one occasion:

> "[I]nsurance[ ] depend[s] on the accumulation of large sums to cover contingencies. The amounts set aside are determined by a painstaking assessment of the insurer's likely liability. Risks that the insurer foresees will be included in the calculation of liability, and the rates or contributions charged will reflect that calculation. The occurrence of major unforeseen contingencies, however, jeopardizes the insurer's solvency and, ultimately, the insureds' benefits. Drastic changes in the legal rules governing * * * insurance funds, like other unforeseen events, can have this effect."

Allied Structural Steel Co., 438 U.S. at 246-247, quoting *Los Angeles Department of Water & Power v. Manhart*, 435 U.S. 702, 721 (1978).

C. 1. a. The Contract Clause of the Constitution forbids precisely the action taken by the Alabama Supreme Court — a retrospective imposition of liability that disrupts expectations based on a contract, imposes a harsh burden on a contracting party, and serves no substantial state interest. Article I, Section 10, Clause 1 of the Constitution provides in part:

> No State shall * * * pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts * * *.

As we have noted, the rights and obligations of appellant and appellees were comprehensively defined by a contract. The Alabama Supreme Court imposed, on that relationship governed by contract, a new duty — not just the duty to process claims in good faith, but an idiosyncratic duty to follow certain procedures. Thus, the action of the Alabama Supreme Court in this case is indistinguishable from the state legislative action that this Court invalidated under the Contract Clause in *Allied Structural Steel Co. v. Spannaus*, *supra*: in addition to "changing the company's obligations in an area where the element of reliance [is] vital" and exceeding the "express terms of the company's contractual obligations" (438 U.S. at 246, 247), the Alabama Supreme Court has "impose[d] a completely un-

expected liability in potentially disabling amounts." *Id.* at 247. "Entering a field it had never before sought to regulate, the [Alabama Supreme Court] grossly distorted the company's existing contractual relationships with its [insureds] by superimposing retroactive obligations upon the company substantially beyond the terms of its [insurance] contracts." *Id.* at 249-250.

Of course, not every state action that impairs or, as in this case, augments the obligations defined by a contract (see *Allied Structural Steel Co.*, 438 U.S. at 244-245 n.16) violates the Contract Clause. See, *e.g.*, *Exxon Corp. v. Eagerton*, 462 U.S. 176, 189-190 (1983). But when, as here, "the state regulation constitutes a substantial impairment, the State, in justification, must have a significant and legitimate public purpose behind the regulation" (*Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411 (1983)). Specifically, the state must show that the impairment is both "reasonable and necessary to serve an important public purpose." *United States Trust Co.*, 431 U.S. at 25; see *id.* at 29.

The question whether a measure is "reasonable and necessary" can be resolved only by inquiring into whether the impairment was carefully tailored to serve the state's interest (see *United States Trust Co.*, 431 U.S. at 29-30) and into whether a "less * * * drastic impairment" — that is, a "more moderate course" — would "serve [the state's] purposes equally well" (*id.* at 30-31). As we have explained, a punitive damages remedy is poorly tailored to the promotion of state objectives even when it is only prospectively imposed, because the amount of an award is arbitrarily determined by a jury and is unrelated to any actual injury. A retroactive imposition of punitive damages in the circumstances of this case, as we have shown, serves no discernible state interest whatever. And even if some slight state interest in deterrence is furthered by a retroactive imposition of liability, a punitive damages award of the magnitude at issue here is a singularly *im*moderate means of promoting it. The Court has commented that "the elimination of unforeseen windfall benefits" may be "a reasonable

basis" for altering a contractual obligation (*id.* at 31 n.30, citing, inter alia, *Gelfert v. National City Bank*, 313 U.S. 221, 233-235 (1941); see, *e.g.*, *City of El Paso v. Simmons*, 379 U.S. 497, 515 (1965)); here, the court below has altered a contractual obligation in order to *confer* a windfall benefit on a party.

b. We recognize that this Court has said that the Contract Clause "is directed only against impairment by legislation and not by judgments of courts." *Tidal Oil Co. v. Flanagan*, 263 U.S. 444, 451 (1924). For several reasons, however, this dictum should not preclude the Court from applying the Contract Clause — or at least the principles underlying the Clause (see pages 27-28, *infra*) — to the action taken by the Alabama Supreme Court in this case.

First, *Tidal Oil* itself and, so far as we can determine, nearly all of the cases on which it relied (see 263 U.S. at 451 n.1) concerned state court decisions construing state statutes. None involved the state action at issue in this case — a *judicially*-created prohibition supported by a punitive remedy.[7] Indeed, subsequent decisions of this Court interpreted *Tidal Oil* to stand for the proposition that "[c]hange by judicial construction *of antecedent legislation* does not impair a con-

---

[7]There is ample reason for distinguishing between a judicial decision that changes a court's interpretation of a statute and a decision that imposes a new duty that is wholly created by a court. When a court alters its interpretation of a statute, it is presumed simply to have corrected an erroneous interpretation. In cases like *Tidal Oil*, there is no contention that the statute, correctly interpreted, impaired the obligation of contract; and in an area governed by a statute, a state arguably should not be said to have impaired the obligation of contract when the statute itself, correctly construed, does not constitute such an impairment. The fact that the court did not correctly discern the meaning of the statute on its first attempt is simply an unavoidable incident of the operation of a state government and does not constitute state action of a kind that is capable of impairing a contract. Cf. *James v. United States*, 366 U.S. 213, 247 (1961) (opinion of Harlan, J.).

By contrast, when, as here, the legislature has not acted in an area and the state permits its courts to create new duties, the action of the court *is* the action of the state. There is no reason for saying that that action cannot impair the obligation of a contract.

tract, at least in the forbidden sense" (*Stockholders v. Sterling*, 300 U.S. 175, 182 (1937)(emphasis added)). So understood, *Tidal Oil* is no barrier to the application of the Contract Clause to this case.

Second, *Tidal Oil* emphasized the language of the Contract Clause, which provides that "[n]o State shall * * * pass any * * * Law" impairing the obligation of contracts. But this language can no longer be — if it ever was — a valid basis for confining the Contract Clause to state legislative action. The First Amendment provides that "Congress shall make no law * * *"; that is, the First Amendment not only refers to "law" but, unlike the Contract Clause, specifically refers to the legislative branch of government. Nonetheless, it is well established that the First Amendment applies to judicial decisions. See, *e.g.*, *Nebraska Press Assn. v. Stuart*, 427 U.S. 539 (1976); *New York Times Co. v. Sullivan*, 376 U.S. 254, 265 (1964); *Bridges v. California*, 314 U.S. 252 (1941).

In addition, since a state is free to "unite legislative and judicial powers in a single hand" (*Prentis v. Atlantic Coast Line*, 211 U.S. 210, 225 (1908)), there is no reason to attribute to the Framers an intention to draw a sharp distinction between the legislative and judicial branches of a state government. So far as the federal Constitution is concerned, it is difficult to identify a principled basis for distinguishing between state courts — which, of course, are not confined to the limited judicial functions specified in Article III — and state administrative agencies. Cf. *Franchise Tax Board v. United States Postal Service*, No. 83-372 (June 11, 1984), slip op. 8-12. Indeed, the unsoundness of the *Tidal Oil* dictum becomes apparent if one attempts to apply it to state actions that are neither purely legislative nor purely judicial. For instance, a state might permit much of its power to be wielded by a state administrative agency acting under a broad statutory grant of authority or by a state official, such as the governor, exercising inherent powers or powers granted by the state constitution. It is implausible to suppose that a state could, by allocating its authority in this way, circumvent the Contract Clause; but that

is the conclusion to which the reasoning of the *Tidal Oil* dictum leads. The actions of state agencies or officials do not constitute "pass[ing] * * * Law[s]" in the ordinary sense of those terms. The actions of a state agency or official acting under a broad grant of authority often closely resemble in appearance — and, for federal constitutional purposes, are logically indistinguishable from — the decisions of a common law court acting under a grant of general jurisdiction. Since it seems evident that the Contract Clause must apply to the former, it should apply to the latter as well.

Finally, we note that applying the Contract Clause to the decisions of state courts will not threaten to convert every state contract action into a case presenting a federal constitutional claim. Many state statutes affect rights established by contract, but the Court has made it clear that not every such statute raises a substantial federal question. See, *e.g.*, *Allied Structural Steel Co.*, 438 U.S. at 241, quoting *Manigault v. Springs*, 199 U.S. 473, 480 (1905). And many other constitutional provisions apply to a broad range of state judicial actions without constantly converting routine state cases into cases raising constitutional issues. For example, not every state court ruling on a procedural issue raises a substantial question under the Due Process Clause; and even though the Court has held that the First Amendment requires exacting scrutiny of damages awards in certain categories of defamation cases, many defamation actions are litigated to a conclusion without raising any serious constitutional issue.

The reason that routine state court decisions dealing with the law of contracts should not give rise to a claim under the Contract Clause is simply that such decisions seldom present a substantial question under Contract Clause doctrine. But if a component of a state government creates a new rule that *does* "impair the obligation of contracts," there is no reason to allow its action to escape scrutiny under the Contract Clause merely because it happens to be a court. In this case and its earlier decisions concerning the tort of bad faith failure to pay an insurance claim, the Alabama Supreme Court functioned much

like a legislature: it considered a broad range of policy considerations and, after due deliberation, it decided to create a new tort and a new remedy. "Legislating" in this way is not necessarily an improper action for a state court; but if it is an action that threatens to impair the obligation of contracts, it should be judged by the same standards that apply to the actions of legislatures.

2. a. Even if the action of the Alabama Supreme Court did not violate the Contract Clause, it violated the Due Process Clause. As we have explained, this Court's decisions (*e.g.*, *Pension Benefit Guaranty Corp. v. R. A. Gray & Co.*, *supra*; *Usery v. Turner Elkhorn Mining Co.*, *supra*) establish that the Due Process Clause imposes certain requirements on a measure that visits retroactive liability on a person. Specifically, a retrospective measure must promote a legitimate state objective that could not be furthered by a strictly prospective measure, and it cannot be unduly harsh and oppressive. See page 13, *supra*. As we showed in Part B, the decision of the Alabama Supreme Court did not meet these standards.

Pension Benefit Guaranty Corp. and *Turner Elkhorn Mining Corp.* dealt with legislation, but the same standards must necessarily apply to judicial action. "The federal guaranty of due process extends to state action through its judicial as well as through its legislative, executive or administrative branch of government." *Brinkerhoff-Faris Trust Co. v. Hill*, 281 U.S. 673, 680 (1930) (footnote omitted). See also *Shelley v. Kraemer*, 334 U.S. 1, 14-18 (1948) (citing cases).

b. In a closely related area the Court has, on several occasions, held that the Due Process Clause is violated by a judicial decision to impose liability for conduct that could not reasonably have been considered wrongful at the time it occurred. *Bouie v. City of Columbia*, 378 U.S. 347 (1964), held that the Due Process Clause prohibites a state from convicting a defendant for violating a statute when state courts interpreted the statute in an unforeseeable way to proscribe conduct that was apparently lawful under the terms of the statute. Although the

Ex Post Facto Clause has been held to apply only to the actions of state legislatures, the Court reasoned that "[i]f [the state] had applied to this case [a] new statute prohibiting [the conduct in which the defendants engaged] * * * the constitutional proscription of *ex post facto* laws would clearly invalidate the convictions. The Due Process Clause compels the same result here, where the State has sought to achieve precisely the same effect by judicial construction" (*id.* at 362). See also *Marks v. United States*, 430 U.S. 188, 192 (1977), quoting *Bouie*, 378 U.S. at 353-354:

> "[A]n unforeseeable judicial enlargement of a criminal statute, applied retroactively, operates precisely like an *ex post facto* law, such as Art. I, § 10, of the Constitution forbids. . . . If a state legislature is barred by the *Ex Post Facto* Clause from passing such a law, it must follow that a State Supreme Court is barred by the Due Process Clause from achieving precisely the same result by judicial construction."

Thus, as these cases hold, the principles of the Ex Post Facto Clause apply to the actions of state courts even though the Clause itself applies only to state legislatures. By analogy, the principles of the Contract Clause must apply, through the Due Process Clause if not directly, to the actions of state courts. The Court has made it clear that the basis of its decision in *Bouie* — the condemnation of the retroactive imposition of liability — is not limited to criminal proceedings:[8] the Court explained that its decision in *Bouie* was mandated by a "basic due process concept" (378 U.S. at 354). For the reasons we have stated, that same concept precludes the irrational and excessively burdensome retroactive punitive damages liability imposed by the Alabama Supreme Court in this case.

---

[8]For example, in *Douglas v. Buder*, 412 U.S. 430, 432 (1973), the Court applied the principle of *Bouie* to probation revocation, even though probation revocation is not a criminal proceeding. See, *e.g.*, *Gagnon v. Scarpelli*, 411 U.S. 778, 782 (1973).

CONCLUSION

The judgment of the Supreme Court of Alabama should be reversed.

Respectfully submitted.

DAVID A. STRAUSS
1111 East 60th Street
Chicago, Illinois 60637
(312) 962-9494
Counsel of Record

Of Counsel:

DARRELL S. RICHEY
Vice President and General Counsel
Golden Rule Insurance Company
Lawrenceville, Illinois 62439

GUY E. MCGAUGHEY, JR.
McGaughey and McGaughey
Lawrenceville, Illinois 62439

AUGUST 1985